PFSWEB INC
Form 10-Q
November 14, 2008

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarterly Period Ended September 30, 2008

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Transition Period from __________ to __________

Commission File Number 000-28275

PFSweb, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**75-2837058**
(State of Incorporation)	(I.R.S. Employer I.D. No.)
500 North Central Expressway, Plano, Texas	**75074**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: **(972) 881-2900**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company þ

Indicate by a check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No þ

At November 14, 2008 there were 9,935,095 shares of registrant s common stock outstanding (after giving effect to the 1-for-4.7 common share reverse stock split effective June 2, 2008).

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PART I. FINANCIAL INFORMATION
ITEM 1. Financial Statements

PFSWEB, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(In Thousands, Except Share Data)

	September 30, 2008	December 31, 2007
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 14,701	$ 14,272
Restricted cash	2,780	2,021
Accounts receivable, net of allowance for doubtful accounts of $875 and $1,483 at September 30, 2008 and December 31, 2007, respectively	41,064	48,493
Inventories, net of reserves of $2,205 and $2,080 at September 30, 2008 and December 31, 2007, respectively	50,005	46,392
Other receivables	12,253	10,372
Prepaid expenses and other current assets	3,126	2,608
Total current assets	123,929	124,158
PROPERTY AND EQUIPMENT, net	12,422	11,918
IDENTIFIABLE INTANGIBLES	5,219	5,824
GOODWILL	15,362	15,362
OTHER ASSETS	990	911
Total assets	$ 157,922	$ 158,173
LIABILITIES AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES:		
Current portion of long-term debt and capital lease obligations	$ 20,802	$ 22,238
Trade accounts payable	62,860	56,975
Accrued expenses	21,265	22,438
Total current liabilities	104,927	101,651
LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS, less current portion	2,535	6,378
OTHER LIABILITIES	991	1,302
Total liabilities	108,453	109,331

COMMITMENTS AND CONTINGENCIES				
SHAREHOLDERS EQUITY:				
Preferred stock, $1.00 par value; 1,000,000 shares authorized; none issued and outstanding				
Common stock, $0.001 par value; 75,000,000 shares authorized; 9,931,137 and 9,909,401 shares issued at September 30, 2008 and December 31, 2007, respectively; and 9,912,776 and 9,891,040 outstanding at September 30, 2008 and December 31, 2007, respectively		10		10
Additional paid-in capital		92,610		92,121
Accumulated deficit		(45,219)		(45,738)
Accumulated other comprehensive income		2,153		2,534
Treasury stock at cost, 18,361 shares		(85)		(85)
Total shareholders equity		49,469		48,842
Total liabilities and shareholders equity	$	157,922	$	158,173

The accompanying notes are an integral part of these unaudited interim condensed consolidated financial statements.

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PFSWEB, INC. AND SUBSIDIARIES
UNAUDITED INTERIM CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In Thousands, Except Per Share Data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
REVENUES:				
Product revenue, net	$ 79,157	$ 85,263	$ 252,496	$ 250,398
Service fee revenue	22,900	18,398	64,966	53,006
Pass-through revenue	7,852	8,334	21,600	21,398
Total net revenues	109,909	111,995	339,062	324,802
COSTS OF REVENUES:				
Cost of product revenue	73,128	78,874	233,475	231,443
Cost of service fee revenue	15,588	12,912	44,537	38,211
Pass-through cost of revenue	7,852	8,334	21,600	21,398
Total costs of revenues	96,568	100,120	299,612	291,052
Gross profit	13,341	11,875	39,450	33,750
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES, including stock based compensation expense of $109 and $172 in the three months ended September 30, 2008 and 2007, respectively, and $438 and $570 in the nine months ended September 30, 2008 and 2007, respectively	12,454	10,678	36,397	32,493
MERGER INTEGRATION EXPENSE				150
AMORTIZATION OF IDENTIFIABLE INTANGIBLES	202	204	605	612
Total operating expenses	12,656	10,882	37,002	33,255
Income from operations	685	993	2,448	495
INTEREST EXPENSE, NET	426	615	1,123	1,857
Income (loss) before income taxes	259	378	1,325	(1,362)
INCOME TAX EXPENSE, NET	216	216	806	683
NET INCOME (LOSS)	$ 43	$ 162	$ 519	$ (2,045)
NET INCOME (LOSS) PER SHARE:				
Basic	$ 0.00	$ 0.02	$ 0.05	$ (0.21)

Diluted	$ 0.00	$ 0.02	$ 0.05	$ (0.21)
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING:				
Basic	9,913	9,889	9,902	9,889
Diluted	9,972	10,113	9,991	9,889

The accompanying notes are an integral part of these unaudited interim condensed consolidated financial statements.

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PFSWEB, INC. AND SUBSIDIARIES
UNAUDITED INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands)

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ 519	$ (2,045)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	4,819	6,108
Loss on sale of assets	17	
Provision for doubtful accounts		208
Provision for excess and obsolete inventory	950	426
Deferred income taxes	42	70
Stock-based compensation	438	570
Changes in operating assets and liabilities:		
Restricted cash	227	(607)
Accounts receivable	7,106	1,596
Inventories, net	(5,252)	3,804
Prepaid expenses, other receivables and other assets	(3,143)	2,009
Accounts payable, accrued expenses and other liabilities	5,585	(10,002)
Net cash provided by operating activities	11,308	2,137
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(4,738)	(2,924)
Proceeds from sale of assets	117	
Decrease in restricted cash		146
Net cash used in investing activities	(4,621)	(2,778)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payments on capital lease obligations	(1,354)	(1,452)
Decrease (increase) in restricted cash	(986)	503
Proceeds from issuance of common stock	50	13
Proceeds from (payments on) debt, net	(3,953)	248
Net cash used in financing activities	(6,243)	(688)
EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS	(15)	435
NET DECREASE (INCREASE) IN CASH AND CASH EQUIVALENTS	429	(894)

CASH AND CASH EQUIVALENTS, beginning of period	14,272	15,066
CASH AND CASH EQUIVALENTS, end of period	$ 14,701	$ 14,172
SUPPLEMENTAL CASH FLOW INFORMATION		
Non-cash investing and financing activities:		
Property and equipment acquired under capital leases	$ 240	$ 2,413

The accompanying notes are an integral part of these unaudited interim condensed consolidated financial statements.

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PFSweb, Inc. and Subsidiaries
Notes to Unaudited Interim Condensed Consolidated Financial Statements

1. OVERVIEW AND BASIS OF PRESENTATION

PFSweb, Inc. and its subsidiaries, including Supplies Distributors, Inc., and eCOST.com, Inc., are collectively referred to as the Company; Supplies Distributors refers to Supplies Distributors, Inc. and its subsidiaries; eCOST refers to eCOST.com, Inc.; and PFSweb refers to PFSweb, Inc. and its subsidiaries excluding Supplies Distributors and eCOST.

PFSweb Overview

PFSweb is an international provider of integrated business process outsourcing services to major brand name companies seeking to maximize their supply chain efficiencies and to extend their traditional and e-commerce initiatives in the United States, Canada, and Europe. PFSweb offers a broad range of services such as professional consulting, technology collaboration, managed web hosting and internet application development, order management, web-enabled customer contact centers, customer relationship management, financial services including billing and collection services and working capital solutions, information management, facilities and operations management, kitting and assembly services, and international fulfillment and distribution services.

Supplies Distributors Overview

Supplies Distributors, PFSweb and InfoPrint Solutions Company (IPS) a joint venture company owned by Ricoh and International Business Machines Corporation (IBM), have entered into master distributor agreements under which Supplies Distributors acts as a master distributor of various products, primarily IPS product.

Supplies Distributors has obtained certain financing that allows it to fund the working capital requirements for the sale of primarily IPS products. Pursuant to the transaction management services agreements between PFSweb and Supplies Distributors, PFSweb provides to Supplies Distributors transaction management and fulfillment services such as managed web hosting and maintenance, procurement support, web-enabled customer contact center services, customer relationship management, financial services including billing and collection services, information management, and international distribution services. Supplies Distributors does not have its own sales force and relies upon IPS s sales force and product demand generation activities for its sale of IPS products. Supplies Distributors sells its products in the United States, Canada and Europe.

All of the agreements between PFSweb and Supplies Distributors were made in the context of a related party relationship and were negotiated in the overall context of PFSweb s and Supplies Distributors arrangement with IPS. Although management believes that the terms of these agreements are generally consistent with fair market values, there can be no assurance that the prices charged to or by each company under these arrangements are not higher or lower than the prices that may be charged by, or to, unaffiliated third parties for similar services.

eCOST Overview

eCOST is a multi-category online discount retailer of new, close-out and recertified brand-name merchandise, selling products primarily to customers in the United States. eCOST offers products in several merchandise categories, including computer hardware and software, home electronics, digital imaging, watches and jewelry, housewares, DVD movies, video games and cellular/wireless. eCOST carries products from leading manufacturers such as Sony, JVC, Canon, Hewlett-Packard, Denon, Onkyo, Garmin, Panasonic, Toshiba and Microsoft.

The Company s liquidity has been negatively impacted as a result of the merger with eCOST. Since the merger, eCOST has experienced a net usage of cash primarily due to losses incurred. As a result, the Company has had to support eCOST s cash needs with the goal of achieving a stabilized operational position and profitable performance. The amount of additional cash needed to support eCOST operations

PFSweb, Inc. and Subsidiaries
Notes to Unaudited Interim Condensed Consolidated Financial Statements

will depend upon working capital requirements, bank financing availability as well as eCOST s continued ability to improve its financial results. Further advances to eCOST may be limited by the Company s current cash and future cash flow and may be restricted by the Company s credit facility obligations.

In the event eCOST is unable to increase its revenue and/or gross profit from its present levels, it may fail to comply with one or more of the financial covenants required under its working capital line of credit. In such event, absent a waiver, the working capital lender would be entitled to accelerate all amounts outstanding thereunder and exercise all other rights and remedies, including sale of collateral and demand for payment under the Company parent guaranty. Any acceleration of the repayment of the credit facilities would have a material adverse impact on the Company s financial condition and results of operations and no assurance can be given that the Company would have the financial ability to repay all of such obligations.

Management currently believes eCOST will meet the Company s expectations related to improved overall profitability. The Company reported improvement in eCOST s financial results during 2007 and the first nine months of 2008 and currently expects continued improvement as a result of efforts to increase sales, improve product mix and control operating costs, although there can be no assurance that these future improvements will be achieved. If eCOST does not meet future expectations, the Company currently anticipates that it would be able to terminate or sublease eCOST s facilities, liquidate remaining inventory through the eCOST website and reduce personnel related costs as needed so as to minimize any material impact upon the Company s other segments.

Basis of Presentation

The unaudited interim condensed consolidated financial statements as of September 30, 2008, and for the three and nine months ended September 30, 2008 and 2007, have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) and are unaudited. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations promulgated by the SEC. In the opinion of management and subject to the foregoing, the unaudited interim condensed consolidated financial statements of the Company include all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of the Company s financial position as of September 30, 2008, its results of operations for the three and nine months ended September 30, 2008 and 2007 and its cash flows for the nine months ended September 30, 2008 and 2007. Results of the Company s operations for interim periods may not be indicative of results for the full fiscal year.

Certain prior period data has been reclassified to conform to the current period presentation. These reclassifications had no effect on previously reported net income (loss) or total shareholders equity.

2. *SIGNIFICANT ACCOUNTING POLICIES*

Principles of Consolidation

All intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of consolidated financial statements and related disclosures in conformity with generally accepted accounting principles requires management to make judgments, estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and disclosure of contingent assets and liabilities. The recognition and allocation of certain revenues and operating expenses in these consolidated financial statements also require management estimates and assumptions.

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PFSweb, Inc. and Subsidiaries
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Estimates and assumptions about future events and their effects cannot be determined with certainty. The Company bases its estimates on historical experience and on various other assumptions believed to be applicable and reasonable under the circumstances. These estimates may change as new events occur, as additional information is obtained and as the operating environment changes. These changes have been included in the consolidated financial statements as soon as they became known. In addition, management is periodically faced with uncertainties, the outcomes of which are not within its control and will not be known for prolonged periods of time. These uncertainties are discussed in this report and in the Company s Annual Report on Form 10-K for the year ended December 31, 2007 in the section entitled Risk Factors. Based on a critical assessment of accounting policies and the underlying judgments and uncertainties affecting the application of those policies, management believes that the Company s consolidated financial statements are fairly stated in accordance with generally accepted accounting principles in the United States of America, and provide a fair presentation of the Company s financial position and results of operations.

Investment in Affiliates

Priority Fulfillment Services, Inc. (PFS), a wholly-owned subsidiary of PFSweb, has made advances to Supplies Distributors that are evidenced by a Subordinated Demand Note (the Subordinated Note). Under the terms of certain of the Company s debt facilities, the outstanding balance of the Subordinated Note cannot be increased to more than $6.5 million or decreased to less than $5.5 million without prior approval of the Company s lenders. As of September 30, 2008, the outstanding balance of the Subordinated Note was $5.5 million. The Subordinated Note is eliminated in the Company s consolidated financial statements.

PFS has also made advances to eCOST, which aggregated $10.6 million as of September 30, 2008. Certain of the Company s debt facilities provide that the total advances to eCOST may not be less than $2.0 million without prior approval of eCOST s lender or increased above $11.5 million without the approval of PFS lender. PFSweb has also advanced to eCOST $4.7 million as of September 30, 2008. PFS has received the approval of its lender to advance an additional $0.9 million to certain of its subsidiaries and/or affiliates, including eCOST, if needed.

Concentration of Business and Credit Risk

The Company s service fee revenue is generated under contractual service fee relationships with multiple client relationships. No clients/customers exceeded 10% of consolidated revenue during the nine months ended September 30, 2008. A summary of the customer and client concentrations is as follows:

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Product Revenue (as a percentage of Product Revenue):		
Customer 1	11%	10%
Customer 2	10%	9%
Service Fee Revenue (as a percentage of Service Fee Revenue):		
Client 1	40%	27%
Client 2	10%	11%
Client 3	6%	13%
Accounts Receivable:		
Client/Customer 1	9%	11%

Client 1 has advised PFS that it is not renewing its contract with PFS, which non-renewal is currently expected to be effective sometime in the first quarter of 2009.

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PFSweb has provided certain collateralized guarantees of its subsidiaries financings and credit arrangements. These subsidiaries ability to obtain financing on similar terms would be significantly impacted without these guarantees.

The Company has multiple arrangements with IBM and IPS and is dependent upon the continuation of such arrangements. Substantially all of the Supplies Distributors revenue is generated by its sale of product purchased from IPS. These arrangements, which are critical to the Company s ongoing operations, include Supplies Distributors master distributor agreements, certain of Supplies Distributors working capital financing agreements, product sales to IBM and IPS business units and an IBM term master lease agreement. Supplies Distributors also relies upon IPS s sales force and product demand generation activities and the discontinuance of such activities would have a material impact upon Supplies Distributors business.

eCOST s arrangements with its vendors are terminable by either party at will. Loss of any vendors could have a material adverse effect on eCOST s financial position, results of operations and cash flows. Sales of HP and HP-related products represented 48% of eCOST s net revenues (11% of the Company s consolidated total net revenues) in the nine months ended September 30, 2008 and 51% of eCOST s net revenues (12% of the Company s consolidated total net revenues) in the comparable 2007 period.

Inventories

The Company establishes inventory reserves based upon estimates of declines in values due to inventories that are slow moving or obsolete, excess levels of inventory or values assessed at lower than cost. Recoverability of the inventory on hand is measured by comparison of the carrying value of the inventory to the estimated fair value of the inventory.

Supplies Distributors assumes responsibility for slow-moving inventory under certain master distributor agreements, subject to certain termination rights, but has the right to return product rendered obsolete by engineering changes, as defined. In the event PFSweb, Supplies Distributors and IPS terminate the master distributor agreements, the agreements provide for the parties to mutually agree on a plan of disposition of Supplies Distributors then existing inventory.

Property and Equipment

The Company s property held under capital leases amounted to approximately $3.6 million and $4.6 million, net of accumulated amortization of approximately $8.0 million and $10.5 million, at September 30, 2008 and December 31, 2007, respectively.

Long-Lived Assets

The Company reviews long-lived assets for impairment periodically, but at a minimum annually, or whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Long-lived assets include property, intangible assets, goodwill and certain other assets. Recoverability of assets is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the assets exceeds the fair value of the assets. Fair value would be determined using appraisals, discounted cash flow analysis or similar valuation techniques. The Company makes judgments and estimates in conjunction with the carrying value of these assets, including amounts to be capitalized, depreciation and amortization methods and useful lives. The Company records impairment losses in the period in which it determines that the carrying amount is not recoverable. This may require the Company to make judgments regarding long-term forecasts of their future revenues and costs related to the assets subject to review.

PFSweb, Inc. and Subsidiaries
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Cash Paid

The Company made payments for interest of approximately $1.2 million and $2.1 million during the nine months ended September 30, 2008 and 2007, respectively. Income taxes of approximately $1.5 million and $1.4 million were paid by the Company during the nine months ended September 30, 2008 and 2007, respectively.

3. COMPREHENSIVE INCOME (LOSS) (in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net income (loss)	$ 43	$ 162	$ 519	$ (2,045)
Other comprehensive income (loss):				
Foreign currency translation Adjustment	(1,041)	255	(381)	252
Comprehensive income (loss)	$ (998)	$ 417	$ 138	$ (1,793)

4. *NET INCOME (LOSS) PER COMMON SHARE*

Basic and diluted net income (loss) per share is computed by dividing net income (loss) by the weighted-average number of common shares outstanding for the reporting period. For the three and nine months ended September 30, 2008, common stock equivalents of 0.1 million and 0.8 million, respectively, of outstanding options are included in the diluted weighted average number of shares outstanding. For the three months ended September 30, 2007, common stock equivalents of 0.8 million are included in the diluted weighted average number of shares outstanding. For the three and nine months ended September 30, 2008, 1.3 million and 0.6 million, respectively, of outstanding options to purchase common shares were anti-dilutive and have been excluded from the weighted diluted average share computation. For the three and nine months ended September 30, 2007, outstanding options of 0.5 and 0.5 million, respectively, to purchase common shares were antidilutive and have been excluded from the weighted diluted average share computation for each period. Warrants not included in the calculation of diluted net loss per share for both the three and nine months ended September 30, 2007 were 0.1 million.

5. *STOCK AND STOCK OPTIONS:*

On June 2, 2008, the Company effected a 1-for-4.7 reverse split (Reverse Split) of the Company s common stock. Pursuant to the Reverse Split, the common stock was combined and reclassified based on a ratio of 4.7 shares of issued and outstanding common stock being combined and reclassified into one share of common stock. No fractional shares were issued in connection with the Reverse Split. Shareholders who were entitled to fractional shares received cash in lieu of fractional shares. All share and per share amounts have been restated to reflect the Reverse Split on a retro-active basis.

During the nine months ended September 30, 2008, the Company issued an aggregate of 182,556 options to purchase shares of common stock to officers, directors, employees and consultants of the Company.

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PFSweb, Inc. and Subsidiaries
Notes to Unaudited Interim Condensed Consolidated Financial Statements

6. *VENDOR FINANCING:*

Outstanding obligations under vendor financing arrangements consist of the following (in thousands):

	September 30, 2008	December 31, 2007
Inventory and working capital financing agreements:		
United States	$ 19,581	$ 23,667
Europe		